Appendix 2

Highlights Day 1:

Merrill Lynch ~~Global Telecom~~ Conference

(Previously published on March 21, 1996)

- **Bell Atlantic's Chairman upbeat re: growth, raising EPS estimates for '96 and '97**: Bell Atlantic (BEL; B-2-2-7, $63 3/4) Chairman/CEO Ray Smith gave an upbeat presentation highlighting the RBOCs and BEL's opportunities to drive growth in the post-Federal telecom legislation environment. Mr. Smith focused on the growth potential from residential second/third lines as well as strong demand for vertical services (i.e., caller id, voice messaging and call waiting) that, combined with price cap regulation, will help to stimulate top line growth in the residential market. In addition, Mr. Smith stressed the growth opportunity from new technologies — ISDN and ADSL (asynchronous digital subscriber line) — which should allow BEL to better meet the demands for internet connectivity from both business and residential customers. Lastly, Mr. Smith expressed optimism that the company will be able to eliminate $300 million in cash expenses this year from productivity improvements. Overall, all of these factors should allow BEL to report top line growth in excess of 5% and EPS growth of 9-10% in both '96 and '97. As a result, we are raising our '96 EPS estimate by $0.05 FROM $4.20 to $4.25 (9.5% growth) and our '97 estimate by $0.10 from $4.55 to $4.65. We believe long distance entry offers further opportunities beyond '97.

- **Panel on RBOC/GTE strategies for entry into long distance.** The three panel members (Steve Nowick from Ameritech, Michael Esstman from GTE and Al Binford from Bell Atlantic) all expressed excitement regarding the LEC's opportunity for long distance entry at very low incremental cost (including capital). All three agreed on six major points: 1) within five years (probably sooner), at least 20% in-region long distance market share is targeted, 2) long distance companies are offering wholesale long distance transport rates of less than $0.02 per minute (vs. retail of $0.10, net of $0.06 access), 3) will initially target the residential and small/medium-sized business customers which comprise over 70% of revenues and even more of profits, 4) once the checklist is met, the opportunity to offer long distance services through local telco channels (e.g., local business offices) and to joint market local, LD and cellular through the LD sub will significantly reduce customer acquisition costs, 5) expect selective long distance facility construction where warranted by high volume traffic patterns between key city pairs (but don't expect RBOC buyouts of LD networks) and 6) our margin assumption (EBITDA and, given low capex, pre-tax) of 25-27% on gross (of access) revenues appears very reasonable given all three panelists' indications that incremental SG&A will amount to no more than 20-30% of gross revenues.

- **NYNEX Chairman highlights the "new" NYNEX:** Ivan Seidenberg, NYNEX's (NYN; B-2-2-7, $50 3/4) Chairman and CEO, provided an overview of the "new" NYNEX, highlighting the following 5 sources for growth going forward: (1) Line growth, stimulated by 2nd and 3rd residential line additions, would continue at 1995's 3.4% rate or better which, though well below the industry average line growth of 3.9% in 1995, was NYNEX's best line growth in 7 quarters. In addition, like the other RBOCs, NYNEX will drive revenue per line by increasing penetration in value added services. (2) ISDN growth: In 1995, NYNEX doubled its ISDN subscribers and plans to continue this rapid growth trend in 1996 and 1997. ISDN is now available in virtually all regions and according to Mr. Seidenberg, "there is no limit to how much they can sell" (3) Cellular: Bell Atlantic/NYNEX Mobile (BANM) continues to grow rapidly and realize synergies from the joint venture. (4) International investments: Dilution from international investment should begin to taper off in 1996 and 1997 contributing positively to year-over-year trends and creating significant shareholder value (e.g. NYNEX's $470 million investment in TelecomAsia is now worth over $1 billion) and (5) Long Distance: NYNEX plans to be ready to enter the long distance business in-region by Oct. 1996 with very little, if any, dilution. Based on Mr. Seidenberg's presentation, we feel very comfortable with NYNEX's ability to meet our 1996 and 1997 EPS estimates of $3.55 (8.2% growth) and $3.85 (8.4% growth) respectively. In fact, we believe our estimates are quite conservative.

- **LCI's Thompson Reiterates Confidence In Co's Growth Outlook, Confirms Our $0.84 EPS Estimate For '96:** LCI International's (LCI; D-3-2-9, $21 1/2) Chairman and CEO, H. Brian Thompson, gave an upbeat presentation emphasizing five key growth drivers: 1) straight-forward, easily understood products offering considerable value to customers, 2) a balanced mix of business including business/residential and wholesale, 3) strong internal growth, 4) emphasis on cost control, and 5) strong and well seasoned senior management team including numerous executives who helped propel MCI in the 1980's. Mr. Thompson also used his presentation to counter earlier comments by RBOC executives that painted very aggressive plans for long distance entry by reminding investors that "... the devil is in the details" concerning the implementation of recently passed Federal telecom legislation. Lastly, Mr. Thompson confirmed that he was "comfortable" with our revenue and earnings growth forecast for '96 (up 60% and 37%, respectively) which equates to EPS of $0.84 vs. $0.61

- **MFS' CEO reiterates expectation of EBITDA break-even by 4Q96, highlights internet opportunities:** MFS Communications (MSFT; D-2-1-9, $62 3/4) Chairman and CEO James Crowe's presentation reviewed his company's strong strategic positioning via local loop facilities in the post-Federal telecom legislation environment. Mr. Crowe repeated his expectation that the company will reach EBITDA break-even no later than year-end '96. In addition, growth of internet-related revenue (approximately 25-30% of incremental revenues in 4Q95) — primarily to internet service providers — should continue to help drive the top line. Looking towards the future, Mr. Crowe offered that telecom networks will begin to look more and more like packet-based internet-like data networks than the voice-based, dedicated circuit model of today's network. Mr. Crowe speculated that if this network architecture transition is rapid, large LD companies may look to acquire MFS. If the transition occurs more slowly, MFS should prosper as an independent company given its strong strategic positioning. Lastly, contrary to earlier forecasts by RBOC executives, Mr. Crowe predicted that internet telephony will eventually become an important product, implying a significant market opportunity to internet infrastructure suppliers like MFS.

- **BellSouth CEO Designate reiterates strong growth story, ready to compete with new entrants:** BellSouth's (BLS; B-2-2-7, $38 1/2) Vice Chairman & COO and CEO Designate Duane Ackerman, like the other RBOCs presenting yesterday, highlighted the company's strategies for growth in the future — strong core business growth driven by RBOC leading line growth and vertical services growth; growing wireless and international contribution; ISDN, Internet, Video and other new services; and long distance entry. BellSouth believes it will have significant resale competition in its region by early 1997 with facilities based competition to follow — leading to in-region long distance entry by mid 1997. BellSouth is targeting 20% share of the $7-8 billion (net of access) long distance market in-region within five years and believes the ability to market long distance service through existing telco business offices (after checklist is met) and using existing sales channels will keep customer acquisition costs to well below the industry average.

  BellSouth is preparing to offer a full bundle of services to customers in the Southeast where it has best brand name recognition. Video trials are going well and BellSouth has detailed video deployment plans in its top 10 markets. It is looking at numerous alternatives for a video offering including both wired and wireless technologies. BellSouth, with over 2.8 million domestic cellular subscribers, was quick to offer cellular long distance as soon as the legislation allowed and has been very successful so far — 85% of all new subscribers chose BellSouth as their long distance carrier. In summary, BellSouth is targeting consolidated revenue growth of 6-7% in 1996 and operating expense growth of 5-6%. Like NYNEX, we are very comfortable BellSouth will meet or beat our 1996/1997 estimates of $2.45 and $2.67, respectively.

- **GTE's Chairman highlights differences/advantages vis-à-vis RBOCs:** The Telecom Act of 1996 provides GTE (GTE; B-2-2-7, $44 1/8) with similar opportunities as it does the RBOCs, except, as Chuck Lee, GTE's Chairman & CEO, pointed out — GTE can start today. They have no checklist requirement, no separate subsidiary requirement and no joint marketing restrictions. In short, GTE can offer a full bundle of services today through existing local telco sales, billing and customer service centers, and has already begun to offer long distance service in Minnesota and Michigan. By June, 80% of GTE's customers will be offered local and long distance service by GTE. The trade-off of course, is that like the RBOCs, GTE will experience competitive pressures in the local market — however, GTE's less densely populated (1/3 of RBOCs) suburban and rural markets make it less attractive to competitors. Like the other RBOC speakers, Mr. Lee believes competitive losses in the local market will be more than offset by long distance and new services gains. The bottom line is that Mr. Lee reiterated GTE's target for 10% EPS growth for the foreseeable" future and stated that he saw no risk of a dividend cut — GTE has $9 billion+ in annual operating cash flow and positive free cash flow that will allow GTE to pursue new opportunities without threat to the dividend.

- **Panel on "What are the real preconditions for RBOC entry"?** While the 2 panel members (Don Reed of NYNEX and Ellen D'Amato of Sprint Long Distance) disagreed strongly on how much real competition the FCC and states might require for an RBOC to meet the facilities-based competition test, they did seem to agree that local bundled resale discounts of 10-20% are likely and that proof of facilities-based competition in one part of a state will qualify that RBOC for long distance service throughout the state. In our view, low resale discounts and a "statewide" approval concept are both very favorable to the RBOC, and indicative of the asymmetric consequences of Congress' simultaneous entry concept.

Appendix 3

Highlights Day 2:

Merrill Lynch Global Telecom Conference

(Previously published on March 21, 1996)

- **AT&T's Nacchio Blasts The "Bell" View Of The Upcoming Bundled, Branded Battle:** Joe Nacchio kicked off day two of the Merrill Lynch Global Telecom Conference. He is AT&T's (T; $61 3/4; A-3-2-7) Executive VP of Consumer and Small Business market, the market segment the RBOCs and GTE plan to target first when they enter long distance. According to day one's presentations by 4 RBOCs and GTE, they anticipate taking 20% market share in 5 years. Mr. Nacchio believes the new entrant could indeed take 20% share of its targeted long distance market because they have nearly 100% share in the local market, have strong brand names in-region and can leverage off existing distribution channels like Yellow Pages — but, he said the 20% share" won't be from AT&T." Mr Nacchio estimates the RBOCs addressable market is smaller than they think ($15-20 billion vs. the total $70 billion US long distance market). He believes that AT&T's strong brand name, *national* presence and competitive experience will give it the strategic advantage it needs to defend its current long distance market share and eventually take share from the RBOCs in the local market. In fact, he believes that the elimination of the local monopoly will lead to an almost immediate flight (about 20% of customers) from the old monopoly provider to new local market entrants. He used California as an example: He estimates AT&T has taken 10-15% of the intraLATA toll market (without dialing parity) in one-year, but we note that PacTel estimates they have only lost about 6% share to new competitors in that time-frame. He did not, however, refute the $0.02/minute (or less) wholesale rate the RBOCs stated they are negotiating for long distance transport from the IXCs (an 80% discount off retail). But, he argued that the local resale rates should eventually move to a 45-50% discount from retail rates, compared to the 10-20% stated during RBOCs and GTE's presentations on day one. Mr. Nacchio's conclusions: (1) RBOC entry will be slower than the RBOCs have indicated, (2) rational long distance pricing will prevail, (3) local resale discounts will be around 45-50%, and (4) there will be facilities based alternatives for local entry (e.g., cable companies, existing CAPs, wireless, new builds).

  Incidentally, AT&T distributed its new 1995 Annual Report at our conference and we note the following excerpt from page 25 "In addition, regardless of provisions for facilities-based local exchange competition, the simultaneous entrance of seven RBOC competitors for interexchange services is likely to adversely affect AT&T's long distance revenues and could adversely affect earnings....Similarly, the impact of AT&T's entrance into local services cannot reasonably be predicted...various factors, including start-up costs associated with entering new markets, local conditions and obstacles and the final form of implementing rules and regulations, could adversely affect future revenues and earnings".

- **Panel Discussion — Strategies For Entering The Local Telephone Market: Resale vs. Facilities-Based:** The three panel members (Ronald Spears from Citizen Utilities(CZNA/CZNB; $11; C-3-3-9), Robert Atkinson from Teleport Communications Group (TCG) and Ronald Gavillet from US Network) all expressed differing levels of interest in pursuing local resale as local service strategy. Unlike his fellow panel members, Mr. Gavillet spoke glowingly of resale as a viable long term local strategy while highlighting US Network's resale agreement with Ameritech for the Chicago market that affords average discounts (across all product lines and includes the impact from term and volume discounts) in the 20% range but did allow that tight expense control (back office and SG&A) and product mix will be the key determinant of profitability. Mr Atkinson from TCG (a leading facilities-based local competitor) championed the view that a pure local resale strategy would "only provide the illusion of competition" while leaving the bottleneck (i.e., the "link" connecting the incumbent local provider's switch and the end user) intact and thus put in a strong vote in favor of narrow enough resale discounts so that construction of alternate facilities are encouraged. Mr. Spears firmly staked out the middle ground between his fellow panelists by highlighting Citizens' three prong local strategy aimed at the provision of bundled services in second/third tier markets that includes a combination of local resale (currently in four Centrex resale deals), construction of local facilities as well as the pursuit of alliances with cable TV companies.

- **Frontier Reiterates Strong Growth Story:** Ron Bittner, Frontier's (FRO; $30 1/4; C-2-2-7) Chairman and CEO reviewed the company's strong outlook for growth (via a three prong strategy of revenue growth, operational excellence and the reliance on strong information systems) as well as updating the audience on a number of issues: 1) he reiterated the slightly cautionary note raised on the 4Q95 conference call that 1Q96 merger synergies were developing somewhat slower than originally expected although the $40 million in targeted synergies for full year '96 was still a reasonable expectation, 2) in Rochester, NYPUC-mandated talks with AT&T continue regarding an attempted negotiated settlement (a combination of higher wholesale discounts — currently mandated at 5% — with AT&T making term and volume commitments), and 3) discussed possible interest in "partnering" for the construction of local (switches, not fiber networks) and long distance facilities in order to improve the economics of local resale as well as its base long distance business. Lastly, Mr. Bittner confirmed that he was "comfortable" with our EPS forecasts of $1.73 for '96 and $2.03 for '97 (up 28% and 17%, respectively).

- **MCI Echos AT&T's Sentiment Regarding Prospects For RBOC Entry:** Doug Maine, MCI's (MCIC; $30; B-3-2-7) Executive VP and CFO, mirrored Joe Nacchio's thoughts regarding its ability to retain long distance customers and gain share in the local market leveraging off its national brand and customer service capabilities. He focused on MCI's experience as the newcomer in the long distance market 20 years ago and its success in tackling the big, powerful monopoly, AT&T (MCI has gained over 20% market share since the breakup of AT&T). According to Mr. Maine, MCI has developed a highly "tuned marketing machine" that has the ability to challenge and win share from the RBOCs in the local market. He spoke with high regard for MCI's experienced and results driven salesforce — a valuable tool for the upcoming battle for share in an even more competitive telecom environment. MCI's salesforce is 10,000 people strong and talks to over 12 million prospects per month. In the past decade, MCI has spent over $2 billion on advertising and in 1995, 30% of its 20 million customers signed up for new services from MCI that didn't even exist in 1994. He also emphasized the quality of MCI network, which in 1995 had half as many outages as AT&T (note: MCI has 1/3 of the traffic).

  Mr. Maine believes that entering the local market is "really quite easy" — MCI plans to enter in 3 ways: (1) Resale will come first , but will be the least utilized means in the long run; (2) Total by-pass of the existing local network will occur over time as alternative facilities are funded and built; and (3) A hybrid solution will be most common once the RBOCs unbundle their networks — i.e. MCI will build transport and switching facilities to a certain point and resell "the last mile" over incumbent local exchange carriers' networks. In response to questions, Mr. Maine expressed the serious possibility that MCI could enter joint ventures/alliances with a competitive access provider and/or AT&T to build alternative local networks.

According to Mr. Maine, MCI will have revenues in excess of $18 billion in 1996. Of the industry growth between 1990-1995, MCI captured 40%. MCI is targeting $30 billion in revenues for the year 2000, which computes to a CAGR of 12.5% and includes an estimated 20% share in the local market. MCI's local market effort will focus on the business segment which is a concentrated market that accounts for 65% of local profits.

In conclusion, the debate and uncertainty regarding the outcome of long distance entry by the RBOCs and local entry by the long distance carriers continues. Based on the presentations given during the first two days of our conference, the RBOCs/GTE believe they will take 20-30% share of the long distance market in region, AT&T and MCI believe they will take 30% and 20% respectively, or 50% collectively of the local market — the latter, in our views, indicative of the incompatible and unrealistic objectives of the various industry players. In contrast, we believe our assumptions, presented in prior reports, are both compatible and realistic: over the next 10 years, the long distance and local telephone industries will likely exchange 20-30% share, with long distance experiencing much higher cost-of-goods sold, higher capex and lower sales and support costs (as percent of local revenues gained) and the RBOC, experiencing the extreme opposite: minuscule capital, huge discounts on leased LD capacity, higher sales/support costs and, if necessary, far more fat (excess cost) to cut. One thing they (and we) all agreed on: the consumer will win and in order to succeed, carriers will need to provide a bundle of services that includes local, long distance, wireless, entertainment and information services, with exceptional customer care and network quality, a single bill and an attractive price. One thing we conclude: the collective targeted share gains and losses of the various industry participants are incompatible.

Appendix 4

Bell Atlantic: Raising '97E by $0.25 For Merger Synergies

(Previously published on April 23, 1996)

Investment Highlights:

- Merger announcement from BEL/NYN should be accretive to EPS in the first year after closing (expected in about 12 months). We are raising our 1997 estimate from $4.70 to $4.95 to reflect merger synergies and our 5 year EPS growth forecast by 200 b.p. from 10% to 12%.

Discussion:

- Yesterday's merger announcement from Bell Atlantic and NYNEX included indications that the deal would be accretive to EPS in the first year after closing (expected in about 12 months) and that synergies would result in $300 million in annual expense savings within a year from closing, growing to annual savings of $600 million by the third year.

- Merging our models for the two companies results in an estimated 1997 net income of $3.75 billion which translates to $3.68 per "New Bell Atlantic" share (i.e., Bell Atlantic and NYNEX combined) which, in turn, translates to $4.79 per old Bell Atlantic share. This compares to our prior "Old BEL" EPS estimate for 1997 of $4.70. We have converted New Bell Atlantic EPS to old by converting each old Bell Atlantic share into 1.302 shares of New Bell Atlantic.

  Merger synergies, i.e., up to $300 million in pretax cost savings within a year of closing, translates to additional earnings impacts. $300 million of savings translates to an after-tax EPS impact of $0.25 per old BEL share; however, we are assuming only two-thirds of the savings occur in calendar year 1997 and thus we are adding a further $0.16 to our EPS estimate, vs the prior ranges of "the upper end of the 7-10%". Accordingly, we have raised our 5-year EPS growth rate forecast by 200 basis points from an already above-consensus 10% to 12%.

- Our new 1997 estimate is driven by cost savings only. The company is targeting an additional boost on the revenue side which is not factored into our revised estimate.

- Beyond 1997, additional cost savings are expected — an additional $150 million in 1998 and then another $150 million in 1999, accumulating to annual cost savings of $600 million by the third year following closing. Annual capital expenditure savings of $250-300 million are also expected.

- One-time transition and integration charges of $500 million are expected in the first year following closing with another $200-400 million expected over the two succeeding years.

Appendix 5

Investment Highlights

Pacific Telesis: Nice Surprise! No Dividend Cut for Now

(Previously published on March 26, 1996)

- Contrary to widespread expectations of a dividend cut, PacTel announced after the close on Friday, March 22 that its Board had decided to maintain its quarterly dividend of $0.545. We believe PAC shares as well as all RBOC and GTE shares will rally. The bearishness that has worked into PAC shares over the past month or so has been overdone, in our view, as has the RBOC/GTE group's "guilt-by-association". PAC's problems are unique and, while often attributed mainly to competition and tough regulators, are primarily due to the heavy PCS capex obligation & dilution (which the others do not have). No change to estimates or rating (B-2-2-8). Concerns of future dividend cut likely to overhang, however.

Discussion

1. **While the Board did not cut its dividend, it did indicate that it "will continue to evaluate the dividend** in light of changing industry, regulatory and competitive developments. The company continues to assess opportunities to invest in new markets which could create growth and strong financial returns for its shareholders over time."

2. We read this statement as suggesting that the Board recognizes that upcoming regulatory decisions such as the CPUC's decisions on universal service (set for August 1996) and unbundled rate elements (year-end 1996) will impact the outlook for Pacific Bell. We also read this statement as indicative of the hopes the Board has for financial upside from long distance entry if the FCC moves expeditiously to implement the new Federal telecom law.

3. **Our conclusions: Our thinking is the Board has taken note of several positive trends**:

   (a) PCS buildout, the primary cause of the cash crunch, is progressing steadily and so far on budget.

   (b) PAC's dividend payout ratio is high as a percent of EPS (87% in 1996, 93% in 1997) but quite comfortable as a percent of cash flow (around 30%).

   (c) 1997's and 1998's capital budgets will decline to $2.2 billion and $2.4-2.5 billion, respectively, significant declines form this year's $2.8 billion.

   (d) Despite intense competition from AT&T, MCI and Sprint for intra-LATA toll since January 1, 1995, PacTel has only lost 6% share since that date and indeed that number has held steady for at least 9 months.

   (e) 1996 is off to a strong start with January and February line and minute growth rates exceeding fourth quarter 1995's 3% and 10.5%, respectively and toll share loss still stabilized at 6% (i.e., no incremental share loss). In this light, our 1996 EPS estimate of $2.50 appears solid at this time although our 1997 estimate of $2.35 could be as much as $0.05 high if the PCS buildout and associated dilution remains on schedule. We believe 1997 will be the bottom in EPS and growth into 1998 could be in the 4-6% range given the turnaround from the PCS dilution and full work through of the January 1, 1995 rate rebalancing and the associated overestimated elasticity assumption.

   (f) The CPUC's recent decision to set interim bundled resale rates at 10-17% below retail rates was not terrible (in our view, at least) since it allows PAC to recover 83-90% of lost local market share until competitors install their own switches and transport capabilities.

Despite the positive trends summarized above, it is likely concerns of a dividend cut will continue to overhang PAC shares as we approach each Board meeting — though we expect the fears to be lighter than this time since the March meeting is explicitly a "dividend policy" meeting and also since few, if any, material regulatory or competitive developments are likely to occur in the next 4-5 months. The universal service decision, expected next August, and the unbundled rate decision expected in December, could lead the Board to take up dividend policy again. At some point, **it's possible the Board could make a statement that the dividend is no longer at risk though we would not expect this until it is clear fair decisions are forthcoming from the CPUC (perhaps middle 1997) or upon FCC approval to enter in-region long distance (say late 1997 or early 1998).**

Our estimates remain unchanged and our rating remains Accumulate (B-2-2-8), the income rating of Same/Lower (8) indicating the risk of a dividend cut.

Table 1

RBOCs & GTE

1996E Dividend Payout Ratios

	Current Dividend	1996E Dividend	1996E EPS	Payout Ratio	1996E CF/Share	CF Payout Ratio	1996E OCF/Share	OCF Payout Ratio
Ameritech	2.12	12	3.75	56.5%	7.82	27.1%	10.37	20.4%
Bell Atlantic	2.80	84	4.25	67.0%	10.22	28.0%	13.07	21.9%
BellSouth	1.44	48	2.45	60.4%	6.11	24.2%	8.43	17.6%
NYNEX	2.36	36	3.55	66.5%	9.55	24.7%	12.81	18.4%
PacTel	2.18	18	2.50	87.2%	7.05	30.9%	9.55	22.8%
SBC	1.65	72	3.42	50.3%	7.20	23.9%	9.59	17.9%
US WEST	2.14	14	2.45	87.3%	7.01	30.5%	9.46	22.6%
GTE	1.88	88	2.87	65.5%	6.58	28.6%	9.84	19.1%
Average				67.6%		27.1%		20.2%

CF = Net Income + Depreciation
OCF = Operating Cash Flow

Appendix 6

Pacific Telesis: CPUC Sets Good Resale Rates; Dividend Risk Analyzed

(Previously published on March 14, 1996)

Investment Highlights

- As expected (and implementing last year's decision to open local telephone service to competition), yesterday the CPUC voted 3-2 to require PAC and GTE to offer 7-17% discounts for bundled local service—a decision that should offer relief to investors concerned about the competitive threats to the RBOCs from the entry of well-branded resellers (e.g., AT&T, MCI, etc.). This is because PacTel and GTE will be able to recover 83-90% of retail revenues lost to facilities-less resellers— a sharp contrast to the predicament of long distance companies that, to the extent RBOCs gain LD revenue share, will recover only 15-20% (1.5- 2.0 cents/min) of the roughly 10 cents currently collected at retail (net of access).

Discussion

1. **Our rating on Pac shares remains B-2-2-8, the "8" indicating the risk of a dividend cut which we consider** a 30-40% chance. PAC's Board will discuss dividend policy, as it does every March, at its March 22 meeting and could decide to continue to pay the $0.545 quarterly dividend (60-70% probability) or it could cut the dividend by, we suspect, 33%. Such a cut would save $300M in cash annually and would, over 3 years, supply the nearly $1 billion needed to complete the PCS buildout. The risk of a dividend cut is real because of: a) its very high payout ratio (87% on 1996 and 93% on 1997 EPS estimates) versus average RBOC payout of 67%; (b) its $1.5 billion capital spend on PCS to replace its spun-off cellular properties versus zero to $200M for other RBOCs; (c) its net cash flow covers only 81% of its capex and dividends versus 114% for the average RBOC.

2. **Resale rate decision, though interim and only for "bundled" resale, was far better than the 20-30% we have been assuming** nationwide and the 25-35% sought by the long distance carriers (they once sought 50%) and is probably indicative of the California Public Utility Commission's (CPUC) recognition of 3 things:

   a) The negative impacts already incurred by PAC from intra-LATA toll competition (which began 1/95) (note: PAC lost an incremental 5 toll share points in first quarter 1995, then only one additional point in the subsequent 3 quarters— suggesting to us, at least, that the toll competitive risk has been overplayed by investors);

   b) The extremely low — below cost — rates in California for basic local service ($11.50/month).

   c) The above average (versus other RBOCs) competitive risk faced in local service and intra-LATA toll by PAC given the attractive size and demographics of the California market, the CPUC's accelerated move to allow new entrants, and PAC's uniquely high risk in intra-LATA toll given the very high 60-70% spread between toll retail rates and intra-state access rates — the latter providing toll competitors such as AT&T, MCI etc. an unusually attractive arbitrage opportunity that is not replicated in other parts of the country. And, besides, PAC's share losses since intra-LATA toll competition was legalized 1/95 have been surprisingly (to us) small at just 6%. (Incidentally, we expect such share losses to triple or more once dialing parity and presubscription for toll services are introduced. However, the new Telecom Act delays this until PAC is authorized by the FCC to provide long distance service to its in-region customers).

3. **What happens if Pacific Telesis cuts the dividend?** At a current yield of 8.0% (one of, if not the highest yields, in the S&P 500), we believe the market has largely assumed PAC will cut its dividend. If we assume the Board does indeed cut the dividend on March 22 (an event we give a 30-40% probability) by an estimated 33% from $2.18 to $1.45, the new 1997 estimated payout ratio based on our 1997 EPS estimate of $2.35 would drop to a quite reasonable 62% from close to 93% currently. An average RBOC dividend yield of 4.5-4.8% would translate, following a dividend cut, into a share price of $30-32 or 12-20% above PAC's current price. On the other hand, if the Board decides not to cut the dividend on March 22, we expect the stock will recover slightly in the short-term, but the possibility of a dividend cut at a later date will likely continue to weigh on PAC shares. Even with this overhang, we calculate an intermediate term price objective of $29-30 (7.3-7.5% yield) or 10-12% upside.

4 **Details on the CPUC's bundled resale decision:** Bundled resale rates are established as retail rates less avoided costs. For residential lines, PAC must offer bundled resellers basic local service at 10% below retail and intra-LATA toll at 17% below retail; however, zero discount will be required for private lines, ISDN, Centrex and special features such as voice mail, caller ID, etc. For business lines, the required discounts are 17% for both toll and basic service. To take advantage of these rates, resellers will have to buy the full bundle of monthly local service, toll usage, and all features from PacTel. These tariffs do not allow a local competitor to selectively bypass some of PAC's local services (resellers must buy the full bundle) and, as such, competitors are not able take advantage of the huge cream-skimming opportunities created by the cross-subsides embodied in today's unbalanced rate structures.

5 **With such a high cost of goods sold, bundled resellers will not make big profits nor will big capital investments be required:** Obviously, this doesn't leave resellers with a lot of room for profit since sales commissions, marketing, billing and customer service costs and price discounts have to be absorbed by the 10 and 17 percentage points of available margin. Low margins in return for low capital investment — that seems to be the rule of the bundled resale game for local resellers lacking buying power. This is the exact opposite of RBOCs reselling long distance, where wholesale discounts are being set by a competitive, not regulatory, process and where the RBOCs will be able to bargain with at least 4 suppliers of long distance transport services for discounts in the range of 80-85% off retail, when measured net of access charges.

6 **Unbundled resale rates by next year but "cost plus" rates will compensate for unbalanced rate structures:** By next January, however, the CPUC intends to set UNBUNDLED resale tariffs (i.e., separate wholesale prices for each element and feature of local service) and then partially-facilities-based resellers will be able to self-supply the low-cost, high priced services (e.g., voice mail, switching, toll and access usage) and simply rent the most capital intensive and difficult-to-replicate part of the local network (the last mile from central office to the end user). However, this is not an easy profit take-away either because the new Federal legislation requires state regulators to set those rates at "cost plus a reasonable profit" — meaning the wholesale rental rate paid for that last mile will be set higher, perhaps significantly higher, than current cross-subsidized retail rates and, consequently, the opportunity for unbundled resellers to cream-skim is mitigated.

7 **Where the money is: full service, fully — facilities-based local competitors:** Facilities-based local competitors, on the other hand, will self-supply all elements of the local network and thus will be able to totally bypass the local incumbent's network, thereby earning high returns on their high up

front investments, offering the most significant competitive threat to the RBOCs — albeit a phased build-out and thus gradual process of revenue and share take-away. Resellers such as AT&T, in contrast, may take lots of revenue share but find themselves paying 70-80% (83-90% in California) of it back to the incumbent RBOC in the form of mandated wholesale rates.

Investment Conclusion:

- For each dollar of revenue share exchanged, long distance companies will lose 80-85 cents due to the huge spread between retail and wholesale rates (1.5-2 versus 10 cents) for long distance transmission and switching. Conversely, incumbent local telcos will lose, e.g., in California, only 10-17 cents for each dollar of share lost- translating into a narrow 10-17% gross margin and likely 3-10% operating margin for resellers of bundled local services. Our conclusion is the biggest long distance carriers will either suffer from the asymmetric economics of resale or they will embark on a capital intensive, time-intensive, dilutive (versus current EPS growth expectations), facilities-based entry into the local market. Either way, EPS disappoints and the value of MFS (MFST, $61, D-2-1-9) grows as the latter's already-in-the-ground assets serve as a shortcut to that end.

Appendix 7

Investment Highlights:

SBC Communications: Raising 1997 Estimate on Strong PAC Earnings

(Previously published on April 25, 1996)

- We recently raised our 1997 EPS estimates for SBC (post PacTel merger) from \$3.60 to \$3.70 following stronger than expected PacTel first quarter earnings. We continue to rate SBC intermediate-term Accumulate and long-term Buy (B-2-1-7).

1. Following SBC's first quarter results we raised our 1996 estimate by \$0.03 to \$3.45, but left our 1997 combined SBC/PacTel estimate unchanged while awaiting PacTel's first quarter results. On April 18 PacTel reported a very strong first quarter and we raised our 1996 and 1997 estimates for PAC by \$0.15 each (see PAC comment dated April 19).

2. Subsequently, we raised our 1997 estimate for SBC (post merger) by \$0.10 from \$3.60 to \$3.70. We now expect only 2.5% dilution as a result of the merger versus our prior estimate of 5%.

3. We continue to rate SBC intermediate-term Accumulate and long-term Buy (B-2-1-7). Given the strength of recent RBOC first quarter earnings reports (including PacTel's and SBC's) and the synergies available in the PAC/SBC merger, we do not rule out the possibility that the merger turns out to be non-dilutive to SBC and that our 1997 estimate for SBC of \$3.80 pre merger is met or exceeded on a merged basis.

Appendix 8

SBC Communications: PAC Merger Positive for all RBOCs, 5% Dilution to SBC

(Previously published on April 2, 1996)

Investment Highlights:

- SBC and PAC have announced a definite agreement to merge. Expect closing early 1997 and 5% dilution to SBC in 1997 but accelerated growth beyond. We believe mergers create synergies and stronger long distance position, thereby enabling all involved to do well for shareholders. Lowering 1997 estimate for SBC from $3.80 to $3.60 and maintaining B-2-1-7 rating for SBC and B-2-2-8 for PAC. Expect additional value-creating merger activity within 2nd tier long distance and among other RBOCs.

Discussion

1. **Mergers are positive and driven by regulatory and federal law changes.** As we have anticipated for over a year, the RBOC merger process has begun but with unexpected, non-contiguous players, PacTel (PAC, $33 5/8, B-2-2-8) and SBC. We view the April 1 announcement of a definitive merger agreement between these two companies as positive for both. This is because (a) merger synergies, which we estimate at $1 billion over 5 years, in SBC's 5-state territory should flow to net income and to shareholders under SBC's 100% price cap regulatory environment and (b) the merged company's cost and effectiveness of entry into long distance should benefit from an enlarged in-region footprint, above-average exposure to high profit/minute international traffic and significant cost sharing — the latter to include billing, customer service, product development, back office, telemarketing, etc.

2. **SBC is paying 32% premium but it is really only 16% after accounting for PAC's dividend cut.** SBC is in effect acquiring PacTel as SBC shareholders will own two-thirds and PAC shares one-third of the company. Each PAC share will be exchanged for 0.733 SBC shares — which means at 4/1 closing prices, SBC is paying $36.56 for each PAC share, equivalent to a 32% premium to PAC's prior day closing price but only a 3.7% premium to PAC's 52-week high. However, the announcement also included a 42% or $0.92/share dividend reduction at PacTel which we estimate transfers roughly $4 per PAC share of present value from PAC to SBC shareholders — meaning the transaction value is closer to the $32-33 range, a 16% premium to PAC 's prior close. (Our math is as follows: The dividend cut results in a $400 million annual cash savings to the merged company of which SBC shareholders should capture two-thirds and PAC holders one-third. Discounting that perpetuity at 12% yields about $4/PAC share of value transfer from PAC holders to SBC holders.)

3. **Expected closing first quarter 1997, one sticky issue at CPUC.** We expect the merger to close in early 1997 after reviews by 7 state regulatory agencies, the FCC and the Department of Justice (the latter for antitrust issues which we do not expect to be roadblocks). Since the deal is a definitive agreement, not a letter of intent or memorandum of understanding, it seems to be on solid ground. We also note no collar has been set — meaning PAC shareholders will get 0.733 SBC shares for each PAC share regardless of SBC's trading price. The only regulatory roadblock of potential significance we can envision is that California law requires merging utilities to pass 50% of any merger cost efficiencies to consumers. However, this is less of an issue than may appear for two reasons. First, PacTel already operates under a rate-of-return incentive sharing regulatory formula that requires earnings between 11.5-15% ROI to be shared 50% and above 15% ROI to be shared 30% with consumers. Second, with PAC already far down the road of process re-engineering and cost reduction, we expect most of the merger synergies to be evidenced in SBC's 5-states (i.e., outside California) and also through more cost-efficient and larger scale startups of new businesses (such as long distance, PCS, internet etc.) With the bulk of these startup efforts to be based in California

and the companies promising California 1000 more jobs as a result of the merger, at this point it is hard to imagine a CPUC commissioner voting against the merger. Nevertheless, we have to caution that nothing is predictable in the regulatory world, especially California's.

4. **5% dilution for SBC but enhanced growth rate.** Given the premium SBC is paying and PAC's heavy PCS development costs in 1997, SBC is expected to incur EPS dilution in the first two years (1997 and 1998). Since the deal is unlikely to be approved before 1997, we are leaving our 1996 EPS estimates for both SBC and PAC unchanged at $3.42 and $2.50, respectively. For 1997, however, we have lowered our EPS estimate 5% from $3.80 to $3.60. From that 1997 base, we expect the merged company to resume SBC's double-digit (10-11% over past 4 years) EPS growth curve as PAC's PCS dilution begins to subside, cost savings especially in SBC's territory begin to develop and PAC's marketing of vertical services (Caller ID, voice mail) and internet, long distance and PCS begin to benefit from SBC's experience with Cellular One. Our estimate for 1998 EPS is $4.00-4.10 (up 11-14%) and $4.60 for 1999 (up 12-15%). SBC management have indicated that by 1999 the merger benefits should be sufficient to offset the dilution and to bring EPS back up the level they would have attained without the merger — which is $4.60 by our estimate for SBC stand-alone.

5. **We continue to recommend SBC shares with a 2-1 rating and PAC shares with a 2-2 rating**. With SBC shares down 5% on the day of announcement, we believe the 5% dilution to be incurred in 1997 is now adequately reflected in SBC's valuation. Nevertheless, with arbitrage pressures likely to linger for awhile, we suspect SBC shares will linger as well.

6. **Expect outperformance from RBOC/GTE group.** We expect the RBOC/GTE group to outperform the market over the next 12 months given its 12% P/E discount to the market yet above market EPS growth (10%), yield at twice the market's (4.9% vs 2.3%) and more defensiveness than the market. At an average 10% premium to the market's P/E, the RBOCs and GTE as a group appear to have 20% price appreciation potential.

7. **Mergers create value so expect additional consolidation. Candidates are FRO AND USW, among others.** We continue to view both the long distance and local telephone industries as likely to experience "within-segment" mergers. In long distance, we believe the process of Worldcom (WCOM; $45 7/8; D-3-2-9) absorbing smaller players will continue with Frontier (FRO, $31.25, C-2-2-7) as the best value and LCI (LCI, $25 1/8, D-3-2-9) also a candidate, though pricier. Our sum-of-the-parts takeout value for Frontier is $40-41. Among the RBOCs and GTE, almost anything is possible as evidenced by the SBC/PAC non-contiguous merger. However, we would focus our attention on the smallest companies in terms of market cap — for example, US West Communications (USW, $33 5/8, B-2-2-7) though acquisition of the latter would require some sort of roll-up and then spin-off of the US West Media Group tracking stock (UMG, $20 3/8). Incidentally, geographically, USW sits right in between PAC and SBC and thus down the road seems a logical candidate for further footprint extension.

Appendix 9

SBC Communications: Mtg. Confirms Growth, LD Opp and Price Cap Kicker

(Previously published on March 14, 1996)

Investment Highlights:

SBC's analyst meeting, held March 12, confirmed our view that the company wi continue to deliver 10-11% EPS and 4-6% dividend growth for the next 5 yrs.; the long distance opportunity is large ($5.7B), with high incremental margins (20-25%), low capex ($100-200M) and extremely low COGS. Indeed, SBC believes its COGS (i.e., wholesale long distance transport) will be below 1.5 cents/mins—far below current retail long distance rate of $0.10/min. and below our prior 2-3 cent estimate!

Discussion:

The following summarizes key items we learned at SBC's meeting:

1. **EPS Forecast and Growth**: Our estimates and 11% 5-year EPS growth forecast remain reasonable.

2. **Dividend Growth**: Management continues to target a 40-45% payout ratio (versus 48% today) by 2000, implying 4.2%-6.5% annual growth. Another dividend increase is expected to be announced March 29. Accelerated stock buybacks are seen as an additional way to share the company's excess free cash flow with shareholders.

3. **Long Distance Opportunity Is High Return And Low Risk**: SBC's long distance subsidiary expects to obtain: (a) FCC approval to offer long distance to in-region customers within 12-18 months; (b) 20-30% market share (of revenues and minutes) of a $5.7B market (excludes inra-LATA toll, includes access), over the next 5-10 years; (c) at incremental operating cash flow, operating income and pretax margins of 20-25% (remember little capex required and thus little depreciation and interest costs); and (d) pay long distance carriers a deeply-discounted wholesale rate for long distance transport of less than 1.5 cents/minute (our prior estimates have been 2-3 cents and were once as high as 4 cents), which is an 80-85% discount from current $0.10 retail rates net of access (i.e., $0.16 gross retail less $0.06 for access equals $0.10 net retail). Total investment required will be $100-200M, including both capitalized plant and expensed systems support. First 2 years or so will be dilutive but these costs are already factored into the "double digit" EPS growth forecast suggested by the company. Note also management indicated their margin plans (20-25%) were derived assuming no synergy between SBC's long distance subsidiary and its local subsidiary. The Telecom Act's separate subsidiary rule (which requires the long distance subsidiary to buy services from the telco at arms length prices), combined with SBC's being 100% price caps means additional margin will be gained on a consolidated basis. As such, we believe SBC's long distance margin goals are conservative and, even so, imply very substantial returns on capital and low risks given the minimal capital requirements outlined above.

4. SBC is not interested in buying a long distance company. However, some sort of partnering or selective outsourcing of long distance marketing activities to LCI, for example, is a possibility.

5. SBC's in-region competitive risk is low, given very low density versus its out-of-region Cellular One properties (145 people per square mile versus 350-450). Widespread flat-rate pricing plans also minimizes opportunities for new entrants to siphon off over-priced usage charges.

6. SBC is already offering long distance service to its cellular customers and, in the Baltimore/Washington area for example, 91% of its new cellular

subscribers signed up last week requested Cellular One (i.e., SBC) long distance service over AT&T, MCI, Sprint, etc.

7. Consolidated capex will remain at current levels ($2.3B/year) for the foreseeable future.

8. Surveys of SBC customers show 71% want to buy multiple service packages (e.g., local plus wireless plus long distance), of which 55% say they would choose SBC, 25% AT&T and 10% others.

9. Whether or not Pacific Telesis (PAC, B-2-2-8, $27 1/8) lowers its dividend at its upcoming March 22 Board meeting, we do not believe that SBC should be considered "guilty-by-association" for numerous reasons: (a) PAC, unique among the RBOCs, is spending $1.5 B on PCS to replace its spun-off cellular properties; (b) SBC's payout ratio is low at 48% (versus PAC's 87% on 1996 and 93% on 1997 EPS estimates.); (C) SBC is funding 137% of its capex and dividends versus PAC's 81%; (d) SBC's EPS growth has been and should continue at 10-11%, versus PAC down 10% in 1995, flat in 1996 and likely down 6% or more in 1997.

10. Federal legislation, in the view of SBC's legal and regulatory experts, allows RBOCs to offer long distance service to an entire state once it has passed the interconnection checklist, public interest test and proven the existence somewhere in that state of an interconnected, predominantly facilities-based carrier offering local service to business and residential customers. This liberal "state-wide" interpretation appears plausible to our legal advisers as well — at least as to Congressional intent. FCC behavior is another matter, however.

Merrill Lynch

20 May 1996

United States

Telecom Services — Long Distance

First Quarter Review: Strong EPS Growth For All; Share Gains For All But AT&T — Value Highlighted At AT&T & Frontier

- We are cautious about most long distance (LD) stocks for two reasons: (1) Near-term, AT&T is beginning to market more aggressively which could dampen MCI's and Sprint's momentum; and (2) Longer term (beginning in 1 1/2 or 2 years), the RBOCs will likely gain FCC approval to offer LD to in-region customers. With low capex required, many willing suppliers of LD capacity at steeply discounted wholesale rates, and established brands and customer bases, RBOC entry will bring a period of P/E multiple contraction among long distance network suppliers.

- On the positive side, telecom legislation will accelerate local competition as the LD quid pro quo will entice the RBOCs to facilitate local inter-connection and unbundling. This will benefit the CLECs (competitive local exchange carriers) such as MFS (D-2-1-9) and also the long distance carriers in the form of lower access costs and potential local market entry.

- Unfortunately, these benefits will take much time and capital and, in the meantime, the LD carriers will sell LD capacity to the RBOCs at far steeper discounts (80% range) than they can buy wholesale local capacity (20-35% range, by our estimates). Herein lies the facilities-based LD carriers' challenge: How to offset the high negative operating leverage of LD share loss with enough access savings and margin on local share gains. Our analysis suggests the net effect is quite negative.

- While neutral on most LD stocks, we highlight AT&T and Frontier as values too cheap to ignore: The "New AT&T" (i.e., post-spin-off) is selling at an implied '97 P/E of 11.5x, far below MCI's and Sprint's 14.6-14.8x. We think the spread will narrow. Frontier is attractive given a P/E below its growth rate and the possibility of takeout at a 30%+ premium. AT&T and FRO are rated intermediate and long-term Accumulate (2).

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435102/435200/435100/435000

20 June 1996

BLS/AT&T Contract Reinforces RBOC/GTE Invest. Case

INVESTMENT HIGHLIGHTS:

- BellSouth (BLS $38 3/8, B-2-2-7) announced a large 3-year contract with AT&T (T 61 1/2, A-2-2-7) for wholesale long distance capacity which will facilitate BellSouth's low cost entry into long distance once approved by the FCC. We believe Pacific Telesis (PAC 33 1/8, B-2-2-8) and SBC (SBC 48 1/8, B-2-1-7) will soon announce (within the next week) similar wholesale agreements with 1 or 2 of the 4 largest long distance carriers at similarly discounted rates of $0.015/minute, or 85% off retail rates, net of access. **We reiterate our positive stance on the RBOCs and GTE.** We are attracted by the EPS boost unleashed by price cap deregulation, by the upside of long distance being sufficient to offset the downside of local losses, and above market EPS growth, yield and defensiveness—all for average P/Es 20% below the market's.

DISCUSSION:

1. On June 19, BellSouth's long distance subsidiary announced a letter of intent with AT&T designating AT&T for a 3 year period as its provider of long distance transmission capacity for calls originating in BellSouth's region and terminating anywhere in the world. **This is the first time AT&T has bid aggressively as a wholesaler to an RBOC and, according to our sources, aggressive it was—beating the 3 other facilities-based long distance carriers**, WorldCom (WCOM 52 13/16, D 3-2-9), Sprint (FON 40 1/4, C-3-2-7) and MCI (MCIC 25 7/8, B-3-2-7). Once BellSouth meets the competitive checklist and receives approval to provide long distance service to its in-region customers (which the company optimistically, in our view, predicts in 1997) and, of course, reaches certain usage volume thresholds, we understand BellSouth will pay steeply discounted average rates in the $0.015 per minute range. This is below the $0.02/minute rate we have been predicting and far below the $0.10 retail rate (net of access) currently collected by these long distance carriers.

2. **Over the next few days, we expect PacTel and SBC to make similar annoucements.** Although difficult to predict given that Sprint and WorldCom have been selected by some other RBOCs, our best guess at this time is that PAC and SBC may choose two suppliers, perhaps Sprint and AT&T.

3. **These announcement further reinforce our view that the RBOCs and GTE** can obtain extremely big discounts on long distance capacity (as much as 85% off retail, net of access) from the 4 existing suppliers and thus **can offer long distance service without the heavy upfront capital investment** that has characterized the phone business, local and long distance, heretofore. Indeed, the existence of a buyers' market for wholesale long distance capacity—which, in turn, derives from the high fixed, low variable cost of running a long distance transport network and the fact there are 4 able suppliers—means the RBOCs can translate a few percentage points of initial long distance market share into the lowest cost of goods sold in the long distance industry and thus the highest potential pretax margins and/or an extra budget for sales, promotion and customer service.

4. **Investment Implications for the RBOCs/GTE are Positive: We continue to recommend the entire RBOC/GTE group with emphasis on SBC, Ameritech (AIT, $57 7/7; B-2-1-7) and BellSouth.** We also see purchase of PAC shares as the cheapest, though riskier, way to buy SBC shares—riskier simply because the merger has not yet been approved. This announcement, along with those pending, provides evidence of the RBOCs' low cost of entry into long distance, except the cost of lawyers at the FCC, and thus the likelihood of earning sufficient margin and profit in long distance to offset the pain of losing local market share. Combined with the unleashing of operating leverage (of cost-cutting and robust new feature sales) that has come with the substantial elimination of ROR, earnings regulations and implementation of price regulations, the RBOC/GTE group now has the ability to grow EPS sustainably for many years in the

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10% range on average, far higher than the 6-7% historical record and far higher than today's bearish consensus. **Obtaining 85% discounts ($0.015 wholesale versus $0.10/min. retail rates) on long distance capacity and giving only 30-35% discounts on local capacity, as we predict will result from implementation of the resale and unbundling parts of the 1996 Telecom Act, is a formula for equal amounts of and thus offsetting competitive gains and losses over the next 5 years or so. Meanwhile, the growth-boosting effects of price cap deregulation, with its incentives to improve efficiency and sell (and invent) more service and features, will plow their way through in above consensus EPS growth rates.**

5 With 10% growth and 4.7% average yields, a 15% total annual return even without P/E multiple expansion above the current 13x 1997 is quite attractive. Add in modest multiple expansion and/or a flee to defensive stocks, and one gets a pretty nice investment profile. **Add in justified multiple expansion, to a market level or 10% above, given above market EPS growth, yield and defensiveness, and one gets an even better investment profile reflecting the exaggerated anxieties of investors** regarding local share losses. Add in some merger synergy, and the earnings go even higher and so should the stocks once evidence develops that antitrust hurdles, if any, will be overcome.

6 **Double-Edged Sword for the Long Distance Stocks:** With AT&T now aggressively bidding for RBOC traffic, it is clear the long distance oligopoly has lost its stability and that when RBOC wholesale traffic begins to grow, the long distance companies will be losing retail minutes and recovering wholesale-priced minutes. As RBOCs gradually build and activate their own switches and in-region inter-city fiber trunks, the RBOCs will self-supply long distance capacity and thus totally bypass the long distance networks—further hurting the revenues and profits of the long distance companies, especially MCI and AT&T with their disproportionate shares of retail-priced minutes. Offsetting this are 3 pieces of good news for the long distance companies: (1) It won't happen overnight, as approvals of RBOC entry are likely to be stretched out over the next few years, with the initial states (NY, Illinois or California) within a year and half; (2) Local share gains as resellers or unbundlers will partially offset long distance losses but unfortunately cannot fully offset them given the asymmetry in wholesale discounts mentioned in #4 above; and (3) AT&T's P/E, net of the spun-off properties, is now 11.4x our 1997 est. EPS of $4.10 and offers an unusual discount to MCI's 13.8x, even after MCI's recent retreat from as high as $30 and 14.8x 6 weeks ago. We continue to believe these two companies' P/Es will converge and thus view AT&T as too inexpensive to ignore despite the asymmetry of cross-entry. AT&T is rated intermediate term accumulate and MCI neutral.

7 **AT&T's newly-found willingness to compete for RBOC contracts is a good sign for AT&T but a negative sign for the other long distance companies.** It means AT&T's management has finally come to terms with RBOC entry risk and the necessity to at least gain back, in the wholesale market, some of the retail share likely to be lost. Though a 15% recovery ($0.015 versus $0.10/minute) still leaves EPS vulnerable to the 85% negative operating leverage, 15% is certainly better than nothing and its better than ceding it to another such as Sprint of MCI or WorldCom—all of whom now have a lower probability of winning RBOC contracts than they did before.

8 **Finally, we note that the BellSouth 3-year contract is for transport and switching only.** Customer service, marketing and billing will be kept in house at BellSouth and not outsourced to AT&T. So far, NYNEX (NYN 45 3/8, RSTR) in its agreement with Sprint is the only RBOC that has outsourced these functions as well as transport and switching. We also believe that over time, when economic volume levels are reached, BellSouth and other RBOCs, including NYNEX, will bring in-house such activities as switching and eventually long haul transport, bypassing entirely the existing long distance networks for some calls. This will start with the in-region city-pairs with the heaviest long distance volumes.

Industry: Telecommunications/Services - Local
Investment Strategy Industry Weighting: INCOME(+),GROWTH(-),CAPITAL APPRECIATION(+)
Technical Analysis Industry Rating: A

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INDUSTRY UPDATE

Telecommunications Services—Mid-1996 Recap

May 22, 1996
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S&P Indus. 799.26

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Rating Changes

On May 10, 1996 we upgraded our rating on four regional Bell operating companies (RBOCs)—Ameritech (AIT-58 5/8-NYSE), Bell Atlantic (BEL-63 1/8-NYSE), BellSouth (BLS-41 3/8-NYSE) and SBC Communications (SBC-49 7/8-NYSE)—from Maintain Position to Accumulate for conservative investors. At their closing prices in Figure #1 on page 2, these four stocks have declined about 14%, on average, from their February highs. They have recently traded as much as 20% off those highs. From Figure #2 on page 2, the average total return for the RBOC group year-to-date 1996 has been -3.82%. By contrast, the 1996 average year-to-date total return for the long-distance index in Figure #2 has been 13.48%. This relative shift in RBOC and long-distance market valuations in combination with our own valuation perspective pertaining to each of these groups has moved us to effect these upgrades.

Background

In late June 1995, after selectively recommending the baby Bells since October 1993, we turned neutral on the group (with the exception of Pacific Telesis which we rated sell) and continued to recommend the long-distance group (AT&T was hold rated subsequent to September 1995) which was recovering from a particularly dismal performance in the fourth quarter of 1994. Figure #3 on page 4, which is a continuation of the performance chart in our January 17, 1996 industry update entitled *Telecommunications Services—1995 Review*, shows that both the RBOC and long-distance groups benefited from the decline in interest rates over the last half of 1995. Again, from Figure #3, the long-distance carriers outperformed from midyear through November 1995, but the RBOCs outperformed over the total second half as speculation heightened in December that Congressional legislation would pass in 1995 and benefit the RBOCs disproportionately. Even so, in mid-January 1996 we continued to selectively favor the long-distance group over the RBOCs stating in our 1995 review that "long-distance shares offer the best near-term return opportunity per unit of risk". On February 13, 1996, we stated that "we would recommend a harvesting strategy in the Bell group moving toward an equal or even an underweighted position".

From their peak in February, the four Bell stocks we are upgrading have declined, on average, by as much as 20% and currently trade, on average, about 14% off their 1996 highs. (See Figure #1.) As Figures #1 and #2 show, the long-distance carriers have outperformed the RBOCs substantially year-to-date 1996. The total return on the RBOC basket has averaged -3.82% year-to-date 1996 versus 13.48% for the long-distance carriers. From July 1, 1995 to date, the total return on the RBOC group has averaged 28.63% versus 36.62% for the long-distance carriers. (See Figure #2.)

Our rating changes are in response to the relative shift in valuations between the RBOCs and the long-distance carriers rather than any change in our opinion regarding the potential beneficiaries of legislation and competition. Our 1995 Review dated January 17, 1996 stated that "we are not negative on the prospects for the RBOC group. Longer term, we believe that deregulation will benefit the total telecommunications services industry..." We continue to believe that longer term deregulation will benefit the total telecommunications industry through the stimulation of overall usage from lower prices, product and service expansion, and penetration of new markets outside the traditional telecommunications markets. Ultimately, the line between local and long-distance service will fade as the regulatory boundaries which have created the distinction disappear. Telecommunications services will

(continued on page 3)

Figure #1

Price Change over Holding Period

Company	2/12/96 - 5/15/96	1/1/96 - 5/15/96	7/1/95 - 5/15/96	12 month Low	12 month High	Close 5/15/96
AT&T	-5.74%	-1.74%	20.05%	$49.13	$68.88	$63.63
MCI	-4.92%	11.00%	31.82%	$19.22	$31.13	$29.00
Sprint	13.91%	29.72%	52.87%	$23.38	$44.00	$42.38
Avg Long Distance	1.06%	13.00%	34.91%			
Ameritech	-12.81%	-1.70%	31.53%	$42.25	$66.88	$57.88
Bell Atlantic	-13.95%	-4.30%	14.29%	$52.63	$74.88	$64.00
BellSouth	-11.26%	-7.18%	27.17%	$29.13	$45.88	$40.38
NYNEX	-14.51%	-11.34%	18.94%	$39.25	$59.25	$47.88
Pacific Telesis	3.86%	0.37%	25.70%	$25.63	$35.25	$33.63
SBC Communications	-16.46%	-12.45%	5.25%	$42.63	$60.25	$50.13
US West	-6.76%	-3.16%	38.55%	$23.41	$37.50	$34.50
Avg RBOC	-10.27%	-5.68%	23.06%			

Source of Holding Period Returns: Bloomberg.

Figure #2

Total Return over Holding Period - Dividends Reinvested in Security

Company	2/12/96 - 5/15/96	1/1/96 - 5/15/96	7/1/95 - 5/15/96	12 month Low	12 month High	Close 5/15/96
AT&T	-5.24%	-1.21%	21.91%	$49.13	$68.88	$63.63
MCI	-4.92%	11.00%	31.95%	$19.22	$31.13	$29.00
Sprint	14.72%	30.64%	55.99%	$23.38	$44.00	$42.38
Avg Long Distance	1.52%	13.48%	36.62%			
Ameritech	-11.37%	-0.76%	35.29%	$42.25	$66.88	$57.88
Bell Atlantic	-12.92%	-2.17%	19.62%	$52.63	$74.88	$64.00
BellSouth	-10.37%	-5.46%	32.22%	$29.13	$45.88	$40.38
NYNEX	-13.50%	-9.30%	23.22%	$39.25	$59.25	$47.88
Pacific Telesis	5.56%	2.02%	34.82%	$25.63	$35.25	$33.63
SBC Communications	-15.[illegible]1%	-11.03%	8.71%	$42.63	$60.25	$50.13
US West	-5.[illegible]8%	-0.01%	46.57%	$23.41	$37.50	$34.50
Avg RBOC	-9.[illegible]6%	-3.82%	28.63%			

Source of Holding Period Returns: Bloomberg.

Sprint 12 month low adjusted downward by $8 to reflect cellular spin off.

The analyst holds a position in the shares of Ameritech, Bell Atlantic and Sprint. A.G. Edwards & Sons, Inc. makes a market in the MCI Corp. shares. For current blue-sky status of OTC stocks, access QBLUE.

(continued from page 1)

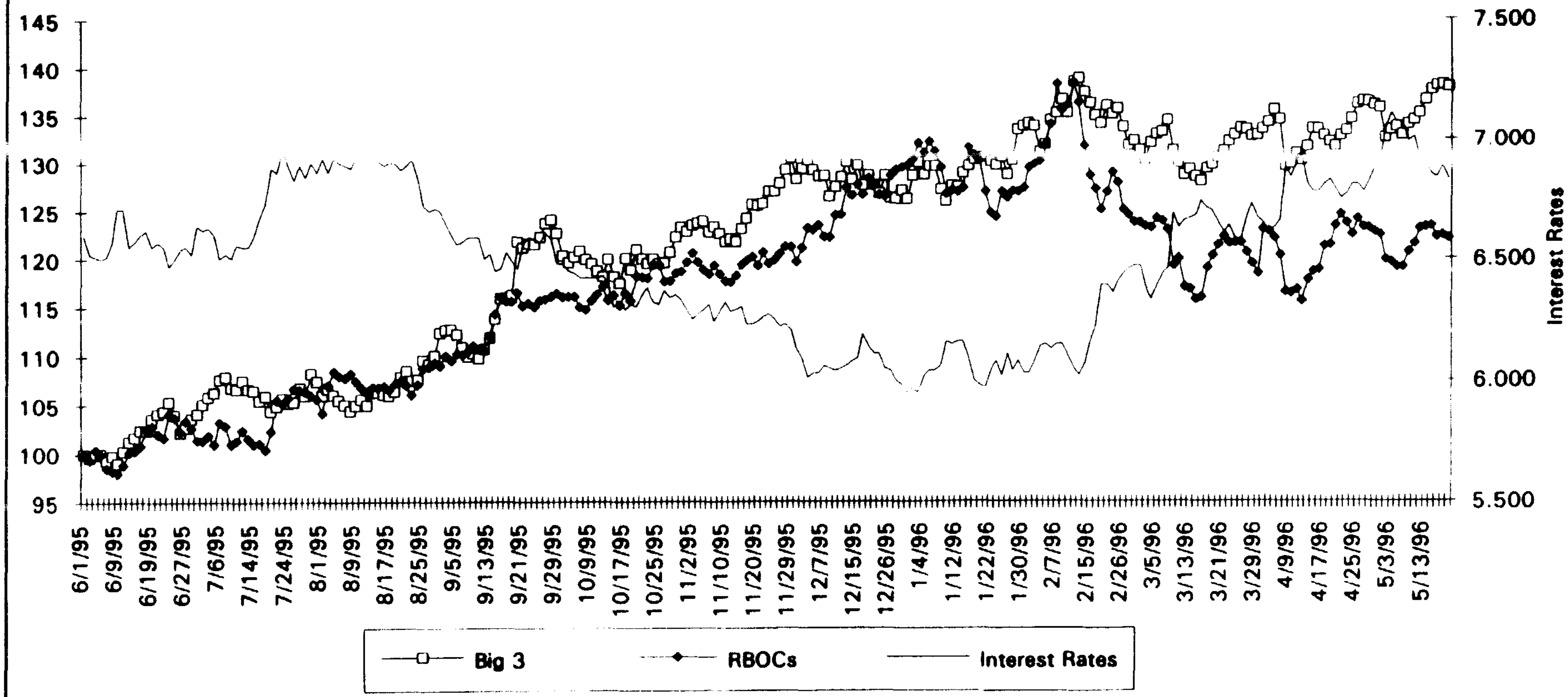
occupy an increasing role in societal functions including the workplace, banking, retail and entertainment services environments. While the industry will look much different, we believe it naive to assume that the surviving entities will be limited to participants in a single segment of the industry as we know it today.

We believe most investors should trade opportunistically around similar dollar weightings in both local and long-distance services companies within their portfolios. The basis for shifting weightings marginally in favor of one group or the other should include relative valuation spreads between the groups, firm-specific criteria and possibly some measure of industry preference. However, we believe that for most clients grossly overweighting one group or the other based on a longer term industry forecast or prediction is extremely risky. This is based on our expectation that winners and losers will not be limited to a single industry group and will emerge over time rather than instantaneously. As this longer term process unfolds however, there will be significant opportunity to marginally shift local and long-distance portfolio weightings opportunistically on a shorter term basis due to relative valuation changes resulting from periods of near-term uncertainty and wavering sentiment.

To summarize our position, the shift in valuations across the local and long-distance industries over the past 12 months has caused us to make slight modifications to our recommended list. We continue to rate MCI (MCIC-29 1/2-OTC) Buy and rank it among our best performance candidates between now and year-end 1996. Sprint (FON-42 3/4-NYSE) also remains very attractive to us but is rated Accumulate after appreciating 30% in the first four months of 1996 and more than 75% since the beginning of 1995. For the first time in nearly a year, we have four regional Bell operating companies on our purchase list with Ameritech, Bell Atlantic, BellSouth and SBC Communications each rated Accumulate. We believe these RBOCs are buyable here as longer term positions and would become more aggressive on weakness. In a 7% long bond environment, we would likely move to an outright buy on these RBOCs if we saw a pullback in price approaching 10% from current levels.

Figure #3

Big 3 price performance versus RBOCs (including UMG & XO)



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Additional Information Available Upon Request

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TELECOMMUNICATIONS SERVICE COMPANIES - OUTLOOK

Telecommunications/Services

Industry Outlook

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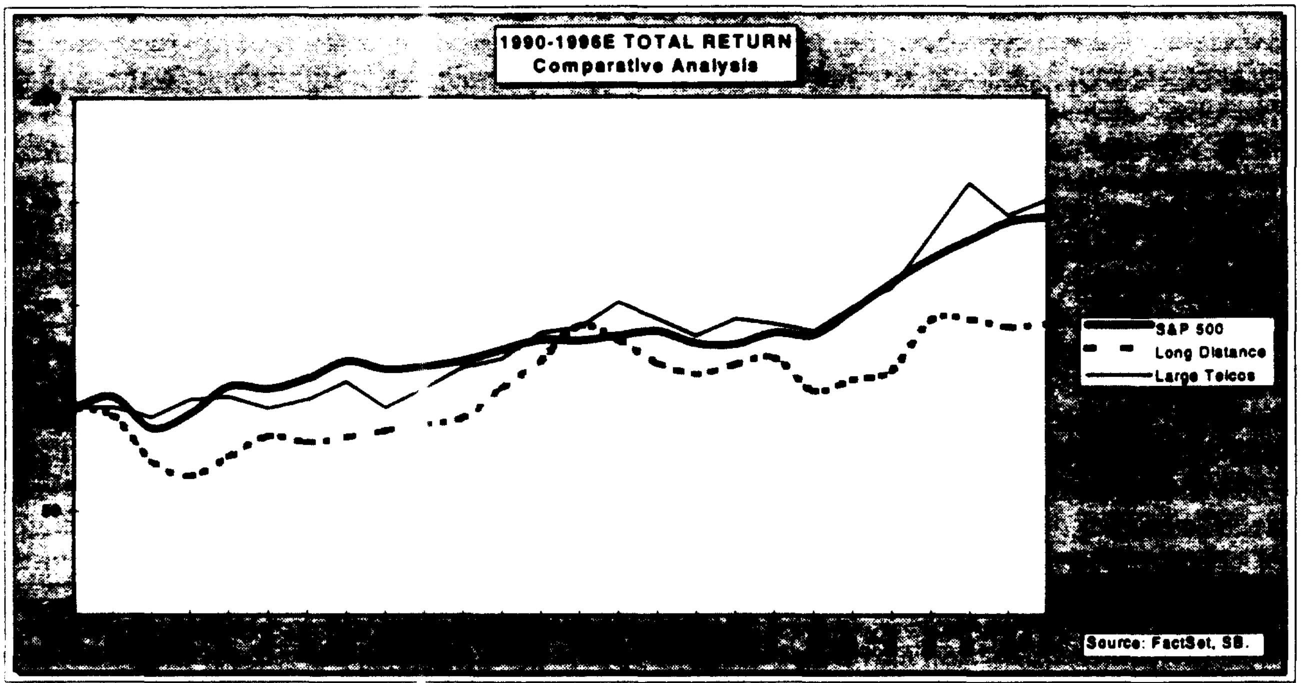

INVESTMENT OPINION AND SUMMARY

We expect telecom industry revenue/earnings growth in 1996 to continue the momentum of 1994/95 *on the core businesses of the major companies*, due to reasonably stable pricing and continued strong demand growth rates. Reported earnings per share growth for individual companies will continue to vary, although less-so than in 1994/95 because of the timing and amount of investments in new businesses, such as wireless, international, and local-exchange/broadband, and the deleveraging of their balance sheets by several companies. *Thus, we believe that reported EPS growth in 1996 will range from 9%-12% for most telephone and long-distance companies although there will be a few outlyers on either side.* The 1997 outlook is more segmented, with long-distance industry growth likely to deteriorate as the Bells enter the market. **Telephone industry growth should remain at robust levels due to: (1) increased regulatory freedom, and (2) the potential of new businesses such as long-distance and broadband.**

In our opinion, 1996/1997 will be a watershed regulatory period for the industry, as the state commissions and the Federal Communications Commission (FCC) implement the recently enacted Communications Act of 1996. This law reduces entry barriers and regulation, and will serve to increase competition in the industry. It will significantly alter relationships within the industry, both in terms of structure and potential growth rates, and create much more